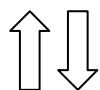


## SUMMARY

### The Bulgarian Economy in Late 2007

#### **Business climate in Bulgaria remains favorable but its dynamics slows down.**



Having registered record-high values over the year, the ESTAT index of business climate falls almost to its early 2007 level. Despite that, it registers the highest January value in the whole six-year history of the index. Similar is the trend identified by NSI's business surveys. From August 2007 on, the record-high business climate levels registered since July 2006 have taken on and maintain a notable downward trend. In December 2007 the indicator already stands at lower levels compared to a year back. Still, the business climate in industry and services continues at high levels and in construction and trade it remains high, although slightly deteriorating.

*However, the slight slowdown of business climate dynamics and deteriorated consumer confidence give us grounds to lower our estimates of total economic growth in 2007 and early 2008.*

#### **Industry continues steady upward.**



Short-term data show that in the first eleven months of 2007 growth in production accelerates to 8.9 per cent against 6.4 per cent in the first eleven months of 2006, depended by a high share of manufacturing where growth accelerates from 7.7 to 8.8 per cent. NSI's January business surveys register increasing industrial capacity load up to 75 per cent – close to the maximum registered in October 2006 (75.3 per cent). In early 2008, the business climate in industry indicator continues at levels close to the peak values registered since mid 2006. In 2007 this indicator did not register high dynamics. Anticipations for the condition of enterprises in the first half of 2008 are optimistic, assessments of the level of foreign and domestic orders are positive. Average supply of industrial production orders measured in number of months improves from 5.2 months in October 2007 to 5.9 months in January 2008.

*Optimistic assessments of current and future production activity prevail. This gives us grounds to expect continuing high growth in industry in a mid-term perspective.*

#### **In the first nine months of 2007 total economic growth is on a slowdown.**



This is attributable to a collapse of this indicator in Q3. According to NSI's preliminary estimates, in the first nine months of 2007 real GDP growth stands at 5.7 against 6.2 per cent for the same period of 2006. In 2007 Q3 alone, growth is 4.5 per cent against 6.7 per cent in Q3 of 2006. On the supply side, two opposite trends are contributive of growth in the first nine months of 2007 against a year back. On one side, value added in the agrarian sector registers unprecedented collapse (down 43 per cent in Q3 and 26 per cent in the first nine months of 2007) and on the other hand, growth in industry and services accelerates further to 10.5 and 9.7 respectively (against 8.8 and 6.4 per cent in the same period a year back). On the demand side, contributive of high GDP dynamics is accelerated growth in internal demand. Investments register again record-high growth (25.9 per cent) on a year-on-year basis against the respective periods from 2001 on. Growth in the individual consumption of households is on a slowdown but nevertheless remains high (6.2 per cent).

*Collapse of value added in agriculture in Q3 of 2007 is contributive of deteriorated total economic productivity in the second half of 2007.*

**We expect GDP growth to register lower levels in 2007 and to restore to values above 6 per cent in 2008.**



Total economic growth slowed abruptly to 4.5 per cent in 2007 Q3 and thus broke the trend of about 6 per cent economic growth registered till mid 2007. Dynamics of growth in value added continues to accelerate in industry and services. Thus the agrarian sector, which registers almost double decrease, is the main contributor of economic slowdown in the second half of 2007. The high economic activity in the other economic sectors registered since end 2006 remains at steady high levels over 2007. There are, however, indications of some slowdown in Q3 and Q4.

*We expect annual total economic growth in 2007 to slow down to about 5.5 per cent and in Q4 to stand at about 5 per cent on a year-on-year basis (against 6.1 per cent annual growth in 2006 and 5.7 per cent in Q4 of 2006).*

*In early 2008 we anticipate slowdown of total economic growth against growth a year back. However, there are grounds to expect that 2008 annual growth will restore to levels above 6 per cent.*

**Current account deficit continues to deteriorate.**



In the first nine months of 2007 it increases on a year-on-year basis from 12.5 to 18.5 of annual GDP. Higher balance of trade deficit (up EUR 1783 m) is contributive of over 80 per cent of current account deficit deterioration (up EUR 2 164 m). EUR 300 m of current account deficit deterioration is formed by decreasing positive balance of current transfers and the balance of net incomes reverses from positive to negative by EUR 173 m. Favorable is only the contribution of the balance of services which is positive over the review period, increasing by EUR 92 m.

*We expect that the current account deficit total for 2007 will go above 20 per cent but in 2008 deficit growth will slow down.*

**Assessments of trends in foreign trade development and inflow of foreign direct investment are not synonymous.**



The balance of trade deficit increases and threatens to become a major risk for the macroeconomic situation in Bulgaria. In the period January – November 2007, the trade deficit exceeds EUR 7.5 b CIF/FOB and is accounted for by higher growth in imports compared to growth in exports. Investment goods, raw materials and energy resources for production consumption account for 84-85 per cent of total imports (CIF) which go to almost EUR 20 b. On one hand, this is a precondition for continued economic growth and securing of export products. On the other hand, however, production based on the import of raw materials, half-finished goods and energy resources is strongly dependent on international prices which are on a permanent upward trend. This leads in the long run to increased cost of goods which become less competitive on the international market. As a favorable trend can be highlighted the higher growth in exports of investment goods and their increased share in total exports, up to almost 16 per cent. This however is not sufficient to conquer the trade deficit. Obviously it is time to take specific measures to change the current situation. There is a need

to focus efforts on the development of export-oriented sectors producing goods of higher value added and based on innovative production. Contributive of that would be a more focused policy for attracting foreign investments in such productions.

*In 2008 we expect growth in exports to accelerate and tend to catch up with growth in imports, based on anticipated higher agricultural yields and accelerated development of export-oriented sectors promoted by investments accumulated in recent years. However, the absorption of European subsidies will have initially a reverse effect and the foreign trade deficit will remain at high values.*

### **Foreign direct investments increase.**



In the first eleven months of 2007, foreign direct investments in Bulgaria amount to EUR 5 b, 30 per cent up on the same period of 2006. Their share in GDP has improved from 15.4 to 17.7 per cent. However, this higher inflow does not exceed the current account deficit in the first eleven months of 2007 reported to date. Coverage is 95 per cent against 124 per cent for the same period of 2006. It is important to note that a large portion of attracted foreign investments goes to the production sector, guaranteeing future export potential, but the inflow of foreign direct investments is, as yet, more a source of trade imbalance and to a much lesser extent - a solution to the trade deficit problem. Bulgaria has great potential and remains attractive for investors. One cannot expect serious decrease of investments in a long-term perspective. The volume of attracted foreign capital may continue to increase or remain at least at its current relatively high level (18–20 per cent of GDP) provided that there are indications for launching of structural reforms and taking of specific measures to improve the business environment (reduce regulations, facilitate some regimes, speed up documents issue, etc.), as well as in case a proactive policy to attract export-oriented investments is implemented.

*Now it is important to act towards changing the structure of investments in order to better link them to export-oriented productions so that the inflow of foreign direct investments leads to growth in exports, hence – to lower negative trade balance. In 2007 we expect the inflow of FDI to stand at about EUR 5.5 b, and in 2008 – at EUR 5.5-6 b.*

### **Inflation accelerates.**



Since the beginning of 2007, inflation in Bulgaria, i.e. the appreciation of consumer goods and services *measured by national CPI*, is 12.5 per cent on December of 2006 (against accumulated inflation of 6.5 per cent for the same period of 2006).


In 2007, the *harmonized consumer price index* registers lower annual appreciation of 11.6 per cent in. However, the prices of the monitored *100 most socially sensitive goods and services* in the small consumer basket register more notable annual increase of 18.9 per cent. A major contributor for the increased general price level registered since mid 2007 is the unusual appreciation of foods in the summer months (respectively by 4.8 per cent in July, 7.3 per cent in August) conditioned by an unfavorable internal and external market environment. Market inertia allowed prices to move up, though at a slower pace, till year end. Foods remain most contributive of the general dynamics of consumer prices and services. Over a year foods have appreciated by 20.8 per cent (December on December) and contribute 7.7 percentage points to total accumulated inflation of 12.5 per cent. In 2007, food prices in the group of the 100 specially monitored socially useful and vital goods and services increased by 26.7 per cent, contributing 15.6 percentage points to the general price index based on the small consumer

basket. *Most accelerated is the upswing up of producer prices in the food industry. Over a year (from November 2006 till November 2007) increase of total producer prices in industry and of domestic market prices is almost the same (respectively 13.3 and 13.2 per cent). Against a year back, most notable is the upturn of prices in the food industry, respectively total increase of 21.7 per cent and 22.7 per cent on the domestic market.*

*The business and consumers anticipate increase of prices. NSI's business surveys in end 2007 and early 2008 highlight anticipations of moderate short-term inflationary pressure in the first months of 2008. Consumer attitudes measured by NSI's October survey show anticipations of further upturn of prices.*

*In 2008, we expect monthly price dynamics to stabilize at lower levels compared to last year. Higher dynamics could be expected after the change in excise rates for cigarettes, petrol and diesel, laid down in Budget 2008, is implemented, as well as following the planned increase of natural gas prices in Q1 and Q2 and of thermal energy prices in Q4. We expect accumulated inflation of about 6 per cent at end of 2008.*


### **Employment increases.**



Employment dynamics remains favorable despite the slowdown of total economic growth in 2007 Q3 resulting in a slower growth in the first nine months of 2007 against the same period of 2006. The economically active population in the country increases at almost the same pace as in the first nine months a year back (by 2.3 per cent against 2.6 per cent in the same period of 2006) and is accounted for by growth in the number of employed persons in the first nine months of 2007 of 4.6 per cent and accelerated decrease in the number of unemployed persons (20 per cent). In 2007 Q3, the share of employed persons remains unchanged in services (56.8 per cent), increases in industry (from 34.2 to 35 per cent) and decreases in agriculture (from 9.2 to 8.2 per cent).

*The lower number of persons outside the labor force and the decreasing number of discouraged persons indicates that the economy generates jobs for people who have not participated in the labor market for some time.*

### **Unemployment continues on a downward trend.**



The number of employed/number of unemployed ratio improves steadily, with continuing increase in the number of employed persons and accelerated decrease in the number of unemployed persons. Thus in the first nine months of 2007, there are 13 employed persons on average per one unemployed person (NSI's methodology) against 9.9 employed persons per one unemployed in the same period of 2006. Unemployment coefficients continue steadily downwards. In 2007 Q3, total unemployment decreases to 6.6 per cent from 8.8 per cent a year back. However, the share of permanent unemployed persons (unemployed for over a year) continues upwards from 56.4 to 60.3 per cent of total unemployed persons. At the same time, the permanent unemployment coefficient (share of permanent unemployed persons in the economically active population aged 15+) improves, decreasing from 5 to 4 per cent of the economically active persons aged 15+. The unemployment coefficient improves most notably in the group of young people between 15 and 24 years – down from 19.4 to 17.2 per cent.

*Accelerated decrease of registered unemployment (Employment Agency methodology) continues. Having dropped for the first time below 8 per cent of the economically active population in May 2007, in the months from September till year end it remained at levels even below 7 per cent.*

### **ESTAT index of business climate registers fluctuating growth.**



Having registered record-high values over the year, in the period October 2007 – January 2008 the ESTAT index of business climate falls almost to its early 2007 level, but at the same time in 2008 it registers the highest January value in the whole six-year history of the index. Identified decrease is in line with the information provided by national statistics and the other institutions operating in the macroeconomic indicators field, which register slowdown of economic growth in the second half of 2007, as well as growth in inflation in December and deteriorated business climate in industry, construction and services. We should add to the above factors also seasonality, which neither in January nor in October had any negative influence, as well as some psychological factors like euroscepticism and criticism of government.

The January value of the ESTAT index is formed by declining values of its all three components, with decline being more pronounced in the condition of companies and the assessments of government's and administration's work and almost negligible in investment attitudes.

The indicator monitoring the *condition of companies* is down 4 percentage points against the value measured in July and October 2007. Having registered a record-high number of companies in a very good condition in October (9 per cent), this indicator now restores to its usual value of about 5 per cent. The highest number of companies in a good and very good condition is registered in the group of enterprises with 10+ employees, as well as in the energy sector, construction, transport and financial services. On the other pole are companies in agriculture 25 per cent of which are in a bad condition according to their managers. Short-range forecasts of company development are sustainable. A prevalent share of about 44 per cent of managers does not expect changes in the first quarter of 2008.



The January survey registers a turning point in respect of company resources, starting with the finding that *almost all companies operating in Bulgaria actually have computers and Internet* and focusing attention thereafter on the satisfaction with the condition of these resources. The survey registers decreased satisfaction of companies with all monitored competitive advantages except personnel skills where satisfaction registers the highest value in the whole index history. At the same time, with the share of managers who could easily find the personnel they needed persisting at a record-low level of 27 per cent, now the human resource crisis registers a new "bottom" level – only 21 per cent in January. Only in construction the shortage of labor is not so pronounced yet. More critical is however the situation in the energy sector and tourism where not more than 10-12 per cent of managers say that they do not have personnel problems.



Even greater is the "retreat" of the State component which fell to its end of 2005 – early 2006 level. This survey highlights some interesting dependencies and trends. First, *business' tolerance to the government and the administration decreases*. If we take the questions containing these two subjects out of the aggregated data, the component value would not register decline but a new peak value. Obtained results are probably due to a "wear out" of the ruling during the last whole year of their mandate and to objective criticism leveled at the majority, as well as to real dissatisfaction with the level of state regulation and administrative pressure. Obvious is business' strive for self-regulation and minimized State intervention.



Complaints about *problems with regulatory base implementation* stand at the level they registered back in 2002 and are by whole 18 per cent higher against 2006. Only 18 per cent of entrepreneurs assess government's legislative initiative as "consistent and non-contradictory".

The share of businessmen who think that it is difficult to start new business in Bulgaria remains constantly high (over 80 per cent).

↑ The positive news outlined in all surveys in the past year is that there is not just higher tolerance to taxation but *satisfaction with the overall tax policy*. On the other hand, the share of those who are dissatisfied with the new social security contributions is high among production enterprises, companies in tourism, agriculture and social activities.

↓ Following the “European” euphoria in the first quarter of 2007, managers relapsed in their previous skepticism. This, as well as the previous survey, registers a record-low share of respondents who agree with the statement that *the harmonization of Bulgarian with European legislation* has improved the business environment in Bulgaria (36.4 per cent). Again particularly critical are constructors, hoteliers, and real-estate and business service companies.

↓ *Public procurement* gets increasingly problematic. Only 6 per cent of entrepreneurs think that procedures are transparent and fair, which is the lowest share registered over the past two years.

↔ Unlike the other two components, *investment attitudes* register minimum drop against the previous quarter from 30 to 29 percentage points and remain at the high level they kept over the whole 2007. In January 2008, investment attitudes are dominated by the mass strive for planning strategically and partnering with those doing business in industry, financial services and the energy sector.

#### **Enterprise policy does not register any developments.**

↔ In the past 2007, *the business environment* in Bulgaria did not register any notable improvement despite the efforts made in that direction. In many spheres results are still to come. More notable change in the conditions for entrepreneurship is expected to occur in 2008 after the Single Commercial Register and the flat tax are implemented.

A start was given to the *absorption of resources from EU's structural funds*. Implementation of Operational Program “Competitiveness” was launched at end of 2007. It provides development incentives for start up innovative companies and entrepreneurship. The first interventions under which invitations for submission of projects have been announced target start-up innovative companies, modernization of enterprises and implementation of internationally recognized standards.

At the end of 2007, the Ministry of Economy and Energy presented its Vision 2013 – a concept for *export policy* of Bulgaria aimed at providing mechanisms to promote export by Bulgarian companies. Unfortunately it does not contain any new workable ideas.

The *public procurement* system redistributes significant from Bulgaria's perspective public funds. According to data from the Public Procurement Register, in 2007 public procurement contracts awarded under the Law on Public Procurement (LPP) and the Ordinance on the award of small public procurement contracts (OASPPC) are 15 300 amounting to a total of over BGN 5 872 m. Prevalence of construction contracts persists. Launched operational programs are expected to contribute to dynamic growth in the volume of public procurement in 2008 and thereafter.

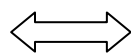
↔ In 2007, *spread of corruption* in Bulgaria does not register significant changes. According to the Global Corruption Barometer published by the authoritative global organization Transparency International in December 2007, in Bulgaria the political parties and the judicial system are ranked as the most corrupt institutions, followed by spheres which are traditionally

perceived as the most affected by corruption: parliament, health care and police. Further anti-corruption measures were implemented in the past year by setting up a State Agency for National Security (SANS). A major line of action of the agency is to detect, counteract and prevent the involvement of high-level state officials in corruption and relations with organized crime. A special anticorruption portal was also created.

Considering *structural reform*, at end of 2007 privatized assets account for 60.4 per cent of total state assets and 91.5 of the assets subject to privatization, at December 1995 balance-sheet value. In 2007 negotiated payments on transactions amount to BGN 311.2 m, and future investments – to BGN 160.6 m. Total financial effect of privatization is BGN 490.3 m. On the whole, there is still lack of a clear concept and political will to restructure and liquidate loss-generating companies and quickly complete the privatization process. Making the necessary changes in healthcare and education, and demonopolizing the energy and the transport sector are not among government's priorities.

### **Social and health policy are exposed to strong public pressure.**

The past 2007 is characterized by intensive pressure for higher wages by a number of professional groups in the public and the real sector. About 20 per cent increase in nominal incomes is expected at year end. Despite that the consumer price index went above 13 per cent in some months, the net effect for the real incomes of the population is positive. Wages in Bulgaria are among the EU lowest. There is undeniable need to increase them but this hides potential risks for competitiveness conditioned by low productivity and less than reliable collective bargaining mechanisms in some branches.



The *labor market* policy remains inactive in respect of labor force quality. Coverage of employment and training programs for disadvantaged groups on the labor market decreased by 22.9 per cent against the previous year. They have provided employment to 54 thousand unemployed persons average per month, down 24 per cent against the previous year.



In 2007, cumulative increase in pensions is about 21 per cent. Despite that, poverty in some categories of elderly people remains an outstanding social problem. The poverty index in the 75+ age group is 27.4, ten percentage points up on the average level for pensioners and 7 percentage points up on 2005. The government failed to fulfill its promise to have pensions granted before 2000 recalculated and the disproportion between old and newly granted pensions will continue to increase.



The fiscal framework for the *income policy* in 2008 is optimistic. Budget salaries and pensions will be indexed by 6.9 per cent at half-year end and the minimum wage has been increased from BGN 180 to BGN 220. These parameters are aimed at increasing real incomes, but that will depend on whether high growth in consumer prices registered in 2007 will be leashed.



In 2007, the *social security contribution* was decreased by 3 percentage points – one point for the Pensions Fund and two for the Unemployment Fund. Total social security rate dropped to 32.5 per cent, about 2 percentage points below the EU average, and the pension contribution remained 0.7 percentage points below the average. Taking account of the positive impact of the lower social security burden on employment, the business circles actively lobby for decreasing it by another 3 percentage points at the expense of higher participation of the state budget in the social security revenues in 2008. The most significant changes are registered in personal income taxation. In 2008, the progressive tax scale is replaced by a 10 per cent flat tax – among the lowest in the EU Member States.



It is *healthcare* again that generates the acutest social policy problems. The regulatory mechanisms introduced in 2007 aggravated the conflict between medical care providers and the National Health Insurance Fund. Despite the monthly monitoring of hospitals, they continued spending more funds than planned and registering dummy activities. Total overspending reached some BGN 90 m, accounting for 13 per cent of hospital care expenditures. Instead of radical changes in the payment mechanism for hospital services, the draft National Health Strategy presented by the government at year end envisages only halfway privatization which is not a way out of the financial collapse.

### **Environmental policy is gaining importance for companies and individuals.**

The past year proved the importance of *government environmental policy* as a determinant of the development of industry, tourism, agriculture and of the quality of the urban environment. Lisbon and Goteborg covenants set new goals in respect of the sustainable consumption of natural resources in the EU Member States and enterprises' responsibilities for the implementation of these goals. 2007 was the first year when Bulgaria participated in the process as a full EU member and so the country was confronted with the need to actually implement undertaken commitments in many areas of the European environmental policy: preserving the biodiversity, waste management, measures to combat climate change, measures to improve prevention and control of industrial pollution and enhance business' and producers' responsibility for the implementation of national environmental goals, etc.



Fulfillment of Bulgaria's commitments under the European bird and habitat directives by building up the scheme of Bulgaria's participation in the *European Environmental Network "Natura 2000"* was a long and contradictory process whose legal regulation was completed in 2007. While procedures for declaring protected areas and for financing of activities therein are still going on in 2008, one can say that the heated battle between environment protectors and investment intentions with disputable economic benefits have ended to the good of public interest and preservation of natural wealth. The next steps in that direction are concerned with the capacity of state bodies to enforce and control the efficient implementation of passed laws and government decisions in the field. The building of environmental network "Natura 2000" will be a test of environmental legislation's capacity to provide a basis for regulating the conflict of private, local and national interests related to the use of national resources.



Arrangements for Bulgaria's participation in the *European Climate Change Program* for reducing and controlling the release of harmful emissions in the air remain unclear. Following reduction by EC of National Allocation Plans and active challenging of this decision in the European Court of Justice, whole sectors of Bulgaria's industry are still not clear about the environment in which companies will operate in the next years and what requirement meeting costs they should plan in their future programs. It is obviously more than necessary to take the dialogue on the specific parameters of the National Harmful Emission Quota Allocation Plan out of the narrow circle of expert discussions as soon as possible and have the structures of MEW, EEA and BIA submit detailed and reasoned evaluation of their positions.

Preparation for absorption of the resources from European funds for improvement and development of environmental infrastructure in settlements was completed. The programming mechanism for the purpose, signed in EC in November 2007, allows for successful absorption of EUR 1.8 b till 2013. Putting in place a clear and open mechanism for submission, evaluation and implementation of projects can make up for the delayed launch of *Operational Program "Environment"*.



### **Banking system development is stable and foreseeable.**

↑ A clear *upward trend in money supply* is registered in 2007, conditioned mainly by high economic growth, increased incomes of households and companies, and the inflow of foreign capital. The mass inflow of foreign capital as a result of a more open national economy following Bulgaria's accession to the EU on 1 January 2007 is the main accelerator of growth in euro denominated deposits. Accelerated growth in deposits with relatively stable growth in broad money is a positive indicator of confidence in the banking system.

↑ In the past year *interest rates* stabilized after a notable upswing in 2006. The major factor influencing annual dynamics is the increase of interest rates on international markets, in particular in the Euro Zone.

Growth in the banking system continues upwards, triggered by *growth in attracted funds and in banks' capital*. Bank loans to the private sector register increase as well. On the whole, the share of bad debts of enterprises and households registers a downward trend over the year.

↑ *Leasing market* expansion continued in 2007. At end September total financial and operational leasing receivables moved up to 5.8 per cent of GDP. Financial leasing receivables account for a major market share.

BNB approved amendments to Ordinance No. 21 on the *minimum required reserves* maintained with BNB by banks and since 1 September 2007 the amount of these reserves is increased from 8 per cent to 12 per cent of banks' deposit base. Increase of minimum required reserves aims at setting bank credit growth rates at moderate and sustainable levels which will not jeopardize banking system's stability. BNB expects the impact of that measure to materialize in two ways: by means of withdrawing of liquidity from the banking system and by means of increasing the cost of attracted resources of commercial banks, which will be transferred over entirely or partially into the cost of credit, and hence will impact the credit demand. Another expected impact of higher minimum reserve requirements is that reduction of bank credit growth rates down to more moderate levels will also relieve the country's balance of payments of the pressure from the strong domestic demand.

In 2007 BNB approved also Main Principles of the BNB Licensing Policy. The basic objective of these principles is to set up clear criteria for the assessment of banking license applicants.

### **Insurance sector expands and registers growth.**

↑ *Income generated by the insurance system* registers sustainable growth. In the first nine months of 2007 it is 20 per cent up against a year back. About 85 per cent of income is generated by general insurance and the other 15 per cent are accounted for by life insurance. Income generated by general insurance registers growth of 19 per cent on a year-on-year basis and income generated by life insurance is up by 30 per cent.

Most contributive of *growth in general insurance* is road vehicles other than railway vehicles insurance, accounting for about 15 percentage points, significant is the contribution of third party liability insurance (about 6 percentage points) whereas the contribution of Green Card insurance is strongly negative (- 4 percentage points). Despite the unfavorable developments in the past few years (floods, etc.), growth in property insurance remains slow at only 0.25 per cent. Most contributive of growth in income generated by life insurance are life insurance policies followed by accidents insurance policies and rents.

*Concentration in the sector decreases* in general insurance as well as in life insurance though more slowly. At September 2007, the top three general insurance companies account for 43 per cent of total sector-generated income against about 49 per cent for the same period of 2006, and the market share of the top three life insurance companies stands at about 59 per cent against 63 per cent a year back.

Approved key amendments and supplements to the Insurance Code, aimed mainly at improving consumer protection and increasing the transparency in doing insurance business, bring in major changes in the *insurance sector regulatory framework*. Amendments concern also reinsurance and claims on insurance and health insurance contracts.

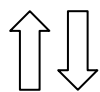
A notable change in mandatory insurance is brought by the Green Card Agreement concerning the coverage of third party liability insurance, which took effect on 1 August 2007. Thus Bulgarian drivers are no longer required to present a Green Card at border control when traveling in the countries of the European Economic Area and in Andorra, Switzerland and Croatia.

### **Capital market experiences foreseeable shocks.**



It has become a rule in the past few years to declare them at year end the most successful for local capital market development. It is true that the end of 2007 marked completion of one more such successful period, and, of course there are serious grounds to say this. Liquidity moves steady upward though it is still far from the usual levels for local conditions.

For example, the daily *trade on the market of shares* tripled against 2006 and the number of transactions moved up by 120 per cent. Total value of transferred securities including negotiated transactions approximates BGN 10 b against a little above BGN 3 b in the previous year. This value, while it may not seem very impressive against developed markets' indicators, is a serious achievement for the local conditions, especially if compared to the stock exchange market capitalization of about BGN 25 b average annual, i.e. the conclusion that can be made for 2007 is that an average of about 40 per cent of the shares registered for trading were transferred. The stir up was largely conditioned by new stock exchange entrants who gave every ground to call 2007 "the year of initial public offerings". Besides, enhanced trade activity was accompanied by notable growth in the prices of the better part of traded positions.



*The main Exchange index – SOFIX*, which is a measure of this growth, moved up by 44 per cent against the previous year and BG 40 registered a far more impressive rise by 160 per cent. It should be noted here that till mid October registered rises were even higher, but then a reversal of the Exchange trend followed and indexes backed down from their record-high values. For example, in the last quarter of 2007 SOFIX fell by about 9 per cent and BG 40 by 8.35 per cent.

The most widely discussed topic in the last quarter of 2007 was whether the market had reached its peak. There was a wide variety of opinions for and against the existence of *overvaluation*. Yet it is known and self-explanatory that markets cannot move only upwards, i.e. it is absolutely normal for decline to follow growth. However, after five successful years in a row, investors seem to have forgotten this truth and the investments of many of them were badly affected by the decline that followed. After all, since markets tend to move upwards in a long-term perspective, the decline that followed should teach the lesson that further market development will reduce the opportunities for quick profits, although a developing market like the local one will remain more than usually swinging.

### **Energy sector remains under the badge of Russian influence.**

↓ In the past 2007 and in the first month of 2008 the three strategic questions of the *Bulgarian energy policy* are: developing new nuclear capacities on the Belene NPP site, negotiating with Russia future supplies and transit of natural gas and developing the Burgas – Alexandroupolis pipeline project. An obvious common characteristic of the three projects is their connectedness with the Russian energy sector and Russian geopolitical interests. Unfortunately, in 2006 and 2007 Bulgaria gave way in all three projects. In early 2008, Bulgaria and Russia signed the construction agreement for the South Stream Pipeline which actually means red light for the Nabucco Project supported by the EU. The Belene NPP project is confronted with its first problems. NEK fails as yet to secure the necessary funds for its share in the project. Selection of a strategic partner is also delayed.

↓ Record-high *natural gas prices* are expected in 2008. SEWRC decided to increase natural gas price, as requested by Bulgargas, in two steps in Q1 and Q2 of 2008. Since 1 January the limit price was increased by 9.87 percent. Growth in natural gas prices will increase significantly the price of central heating in the 2008/2009 heating season.

### **Problems in the transport sector remain outstanding.**

↓ Two years in its second mandate, the government has failed as yet to execute any *highway or railroad infrastructure* concession agreement. It is these two sectors that the 2005 government program highlights as the most promising and profitable for public-private partnership. At the end of 2007 the government finally launched the Trakia Highway and the contract will take effect from the signing date of the second annex thereto. Lack of transparency about Trakia Highway concession conditions discredited the transaction, leaving the impression that once again state interests will not be protected.

↓ 2007 failed to bring any solution to the *state railways* crisis – passenger carriage continues to accumulate losses and the profitable cargo carriage suffers from lack of cars. The poor condition of the railway infrastructure is the main obstacle preventing BDZ from providing faster transport services of higher quality.

↑ The past 2007 was Bulgaria's first year on the liberalized European market of passenger *air carriage* "Open Sky". It is end-users who benefited most because of lower ticket prices for the busiest destinations now flied also by low-cost air carriers. These companies registered top growth in their market share to about 15 per cent.

### **Construction and real estate are development leaders.**

↑ In 2007 *growth in construction* is 15 per cent, placing the sector among Bulgaria's development leaders. Construction boom is underpinned by shortage of modern residential, shopping and administrative space, warehouses and logistic centers. In the first year of Bulgaria's EU membership prices of construction materials and related services moved up by 12.6 per cent on average. In 2008 they are expected to register lower increase at some 11.8 per cent, depended by higher international prices of materials and higher service prices on the local market.

An active construction sector promotes property related activities. The record-high turnover of EUR 11.4 b makes the *property market* total leader of 2007. January 2008 data by Global Property Guide show that in 2007 Bulgaria registers world's highest property price growth at

30 per cent. A housing price “balloon” is spoken of. However, there are no serious grounds as yet to expect fall of prices in the sector.

↑ In 2007, the tendency to *buy homes on credit* persisted and the last month of 2007 saw record-high growth in lending in terms of both volume and amount. According to sector experts, it is depended by rising property prices and perceptions of continued price growth. Most banks have increased the coverage of mortgage loans from 70 to 90 per cent. The BGN 100 thousand psychological barrier was crossed and the average amount of loan taken reached EUR 51 148.

At end of 2007, the *shopping space market* was extra dynamic. There is demand of alternative spaces near operational shopping centers. Office space demand is expected to remain stable in 2008.

Construction dynamics calls for putting in place a modern and adequate *regulatory base*. However, the Law on the management of condominium ownership in residential buildings was not passed in 2007. Because of a three year delay, till 2010 Bulgaria will not receive funds under the Housing Policy measure of EU’s Operational Program “Regional Development”. Following a couple of attempts for introduction in the National Assembly, the Government finally gave green light to the Bill concerning about 4 500 thousand people living in blocks of flats. In connection with the Law on Chamber of Builders, all Bulgarian and foreign companies have to register in the Building Register in order to do business. Excluded are only companies implementing low-rise construction of small residential or mixed buildings, and repair companies. In 2008 the construction ministry will implement Eurocode 8 – design of structures for earthquake resistance. By 2011 all EU Member States are required to implement the Eurocodes in construction.

### **High technology comes in strong in economy and business.**

↑ *Information and communication technologies* are coming into their own in the life of Bulgarians, show recent NSI’s surveys from 2007. Over 80 per cent of enterprises and almost one-fourth of households use personal computers, and Internet connectivity moved 10 per cent up in both groups to 88 and 19 per cent respectively.

Analysts from IDC Bulgaria also report positive assessments and anticipations of Bulgarian *IT market* development – they estimate growth in 2007 at about 25 per cent and project it at around 15 per cent in the next 4 years.

### **Tourism develops, however not in a clear direction.**

↑ ↓ Despite the key role of tourism in the Bulgarian economy, 2007 was another *hard* year for its development – no strategy, no defined priorities, inadequate advertising funds, disunited branch organizations and shortage of professional labor.

According to NSI’s data, in the first nine months of 2007 the number of foreign *tourists* visiting Bulgaria is 3.9 m people. In the period January – September, the number of nationals of EU countries visiting Bulgaria moved up by 31 per cent and EU tourists account for the highest relative share – over 70 per cent of total foreign guests. Significant is the increase in the number of tourists from Romania – over 500 thousand people. At the same time, serious fall off is expected in the number of Serbian and Macedonian nationals.

In the past years German tourists’ interest in Bulgaria is declining – in 2007 only 1.5 of per cent of total German tourists spent their holiday in Bulgaria. Bulgaria is not in the top ten

holiday destinations of West Europeans. Most sector experts assess the past summer season as relatively successful. Good results are expected for the winter season as well – conditions in mountain resorts are favorable, the base has been significantly rehabilitated and expanded – facilities and ski tracks, in particular in Bansko, are very up to date. On the whole, however, the number of winter season guests is not expected to exceed last year levels.

↑ A new positive trend in tourism emerged at end of 2007 – tour operators and hoteliers go back to *Bulgarian nationals*. A Bulgaria – Paradise for Bulgarian campaign was launched, incentives are envisaged for Bulgarians who spend their holiday in national resorts.

### **Agriculture fails to realize its potential.**

↓ 2007 will be remembered for the *notable slowdown of agricultural production* depended by bad weather conditions. In 2007 Q3 value added generated by the sector dropped by 43 per cent in real terms against the same period of 2006. In the first nine months of 2007 the relative share of agriculture in total value added decreased to 6.9 per cent and its share in GDP – to 5.7 per cent against 9.2 and 7.5 per cent respectively a year earlier.

Despite the collapse depended by inefficient agrarian production and strong dependence on weather conditions, *the development potential of the sector* is assessed as relatively high. It becomes increasingly attractive to invest in agriculture and some specialized land investment funds have come to the conclusion that development of own production yields higher return than granting on lease. Future sector growth will be underpinned by a steady upward trend in the prices of foods globally conditioned by increasing demand and limited production capacities, the policy for encouraging bio fuel production and the subsidies provided under the EU Common Agricultural Policy.

↑ Bulgarian farmers will receive the agreed *annual direct eurosubsidies* of BGN 14 per decare of arable land. In Budget 2008 direct payments account again for over 50 per cent of CAP expenditures and even a portion of the funds for rural development are reallocated to finance direct payments. One should not forget, however, that a CAP reform is pending, in particular reform of the system of subsidies towards reduction of direct payments for bigger farms and change of the payment scheme. Proposals concern in the first place the direct payments policy and envisage shift of resources to finance the development of agriculture and rural regions as a whole.

The sector has high growth potential on the basis of significant *modernization of agricultural production* and accelerated mechanization called for by labor shortage and appreciation. Introduction of advanced technologies and new machines, using the opportunities provided by European funds and investment lending programs, will improve sector's productivity and competitiveness and will also encourage farm land consolidation and better use. The improved structure of farms will call for building many new and restoring existing hydro facilities and transport infrastructure attendant to farm estates. Indicative of agriculture's future development is the significant upward trend of transactions in farm land and a strong investors' interest in regions that until recently remained beyond their attention. Besides local investment companies, foreign investors planning their investments in a single European market perspective and looking for any opportunity to increase their earnings yield, are also expected to step in.

## **EU structural funds and regional policy are the focal point of our first year of EU membership.**



The past 2007 was a very important year in terms of *working up the whole process for absorption of resources from EU's structural funds*. This involves preparatory work which the government had to accomplish, but also making the business, the municipalities and the civil society ready to develop quality projects. In early 2007 the Bulgarian government submitted the package of strategic and programming documents (NSRF and the 7 OPs) to the EC in Brussels. Following analyses and corrections, in the second half of 2007 the documents were approved. Operational programs are among the first financially secured instruments for government intervention setting specific objectives, deliverables, supported by monitoring and performance assessment indicators.

OP implementation was officially launched by giving start to the *first procedures for submission of project proposals*. Selected were also the first projects under some OPs. OP Regional Development started with submission of projects under Priority 2 – Regional and Local Accessibility – for reconstruction and rehabilitation of class 2 and 3 roads and roads from the municipal road network.

In 2007, the practice of assigning *credit ratings to Bulgarian municipalities* gained further foothold. Having a credit rating is very important for municipalities, in particular after Bulgaria's accession to the EU. It opens up new horizons to local authorities and can be used to negotiate better conditions when applying for credits, issuing bonds and submitting projects for programs of the European funds.



In the past few years *municipalities are improving their financial condition*. October 2007 data of municipalities' revenue execution show 148 per cent increase of own revenues against the same month of 2006.

A *new country zoning* in line with the Common Classification of Territorial Units for Statistics (NUTS) was announced at end 2007. The Regional Development Act was amended and government approved amendments in December 2007. The country will be divided in three levels of regions towards sustainable and balanced regional development. The new zoning is expected to decrease inter- and intraregional differences by creating conditions for accelerated economic growth, higher employment and promotion of regional cooperation.